

Internal Revenue Service
memorandum

CC:TL-N-1233-91
Brl:TDMoffitt

date: FEB 11 1991

to: District Counsel, Manhattan CC:MAN

from: Assistant Chief Counsel (Tax Litigation) CC:TL

subject: [REDACTED]

This is in response to your request for tax litigation advice dated November 9, 1990.

ISSUES

1. Is [REDACTED] and its subsidiaries, including [REDACTED] (hereinafter collectively referred to as "[REDACTED]") entitled to use the last-in, first-out (LIFO) inventory method for federal income tax purposes. 0471-0100; 0472-0100; 0472-1300

(i) Does LIFO clearly reflect [REDACTED]'s income.

(ii) Is [REDACTED] a dealer in securities pursuant to the provisions of Treas. Reg. § 1.471-5.

(iii) Did [REDACTED] properly elect LIFO.

(iv) Did [REDACTED] comply with the conformity requirements of I.R.C. §§ 472(c) and 472(g).

2. If [REDACTED] is entitled to use LIFO, what is the standard for determining whether DBL properly grouped goods into pools in accordance with Treas. Reg. § 1.472-8. 0472-0700

3. If [REDACTED] is entitled to use LIFO, what is the standard for determining whether [REDACTED] properly placed items into pools in accordance with Treas. Reg. § 1.472-8. 0472-0800

CONCLUSION

1. The entitlement of [REDACTED] to the use of the LIFO method is a factual question. Based on the facts as set forth in your memorandum of November 9, 1990, it would appear that [REDACTED] properly elected LIFO, is a "dealer" under section 1.471-5, has complied with the conformity requirements in all documents which we have reviewed, and is therefore entitled to use LIFO.

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2. The standard to be used in determining whether [REDACTED] properly grouped goods into pools in accordance with section 1.472.8, as discussed below, indicates that [REDACTED] did properly group goods into the appropriate pools.

3. The standard to be used in determining whether [REDACTED] properly placed items into pools, as discussed below, indicates that further factual development is necessary to determine the appropriateness of the inclusion of goods in single item categories by [REDACTED].

FACTS

[REDACTED] is in the business of investment banking and is also a securities broker-dealer providing financial services. It uses the overall accrual method of accounting and is a member of an affiliated group of corporations filing a consolidated return. [REDACTED] is currently in the bankruptcy court.

[REDACTED] initially elected the LIFO method for its inventory of precious metals beginning in [REDACTED]. It subsequently elected LIFO for its inventory of corporate bonds (excluding stripped bonds and zero coupon bonds) in [REDACTED], for its inventory of U.S. Government and Agencies notes, bonds and mortgage backed securities for [REDACTED] and for its inventory of state and local municipal obligations with a stated interest rate in [REDACTED].

Each year when it first elected the use of LIFO for a particular subsidiary's selected inventory, [REDACTED] filed a Form 970 with the appropriate return. In electing LIFO, [REDACTED] stated that it was applying the link chain method for some of the inventory but did not explain the link chain method in detail, including how the link chain method would be calculated. [REDACTED] stated that it was applying the double extension method to other inventory. [REDACTED] only gave a general explanation of why it is using the link chain method instead of the index or double extension method. [REDACTED] did not use the consumer price index nor producer price index, but rather developed its own index without explaining the index on its return or Form 970. [REDACTED] simply attached a statement from its accounting firm that [REDACTED] was using LIFO for the given inventory and that LIFO does not conform with Generally Accepted Accounting Principles (GAAP).

[REDACTED] is not a publicly traded company. It did, however, have reports called Annual Reviews for a given year. These reports provided a Consolidated Statement of Financial Condition (CSFS) stating assets and liabilities of [REDACTED]. Consolidated Financial Statements (CFS) were separately prepared by [REDACTED]'s accounting firm stating [REDACTED]'s assets and liabilities as well as revenue, expenses and net income among other items.

The CFS stated that [REDACTED] was using LIFO for certain inventory

and that LIFO does not conform with GAAP. The CFS then presented certain inventory as assets and revenue based on the LIFO method. The CFS proceeded to state that GAAP requires inventory to be valued at market. The CFS then presented amounts for the inventory at market instead of LIFO.

By comparison to the CFS LIFO amounts, the amounts for assets in the Annual Review CSFC are different and are stated to be at market. Thus, it appears that the asset amounts in the Annual Review are not using LIFO. The Annual Reviews also present graphs reflecting gross revenue. The gross revenue is reflected by reference to a base year index rather than stated gross revenue. Calculations are necessary to compare the graph to the CFS. It appears that the Gross Revenue graph follows the LIFO revenue amounts in the CFS statement. Thus, it appears that a non-LIFO method was used for assets but a LIFO method was used for income in the Annual Reviews.

The LIFO method would result in lower values for the assets in [REDACTED]'s inventory than would a FIFO method. Since the values of the assets in [REDACTED]'s inventory under LIFO on [REDACTED]'s returns appear to be lower than [REDACTED]'s debts on [REDACTED]'s returns, it appears that [REDACTED]'s inventory may have been valued using the FIFO method for the purpose of obtaining loans from creditors. Thus, it appears that [REDACTED] might have presented reports to creditors such as banks using FIFO rather than LIFO to justify loans to [REDACTED].

Not all [REDACTED] companies used the LIFO method.

[REDACTED] pools gold, silver, platinum and another precious metals even though these items have very different markets. [REDACTED] pooled government securities at different rates. [REDACTED] also pooled corporate securities and notes together.

DISCUSSION

I.R.C. § 471(a) provides that when the Secretary determines that inventories are necessary to clearly determine income, inventories shall be taken by the taxpayer on such basis as the Secretary may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting income.

I.R.C. § 1.471-5 provides that a dealer in securities in whose books of account separate computations of the gain or loss from the sale of the various lots of securities sold are made on the basis of the cost of each lot shall be regarded as regularly inventorying his securities at cost. For securities to be treated as inventory, they must be held by a dealer for sale to customers in the ordinary course of business. A "dealer" in securities is a merchant of securities, regularly

engaged in the purchase of securities and their resale to customers. For purposes of this section, a dealer in securities is a merchant of securities with an established place of business; one who as a merchant buys securities and sells them to customers with a view to the gains and profits that may be derived therefrom. If [REDACTED] factually meets this test then it is a "dealer" for purposes of section 1.471-5. You state that [REDACTED] had an established place of business as an investment banking firm and bought and sold securities in its account for sale to customers. As such, it would appear that [REDACTED] was, in fact, a "dealer" for these purposes.

Section 472(a) provides for the use of LIFO, and the method of change thereto. Section 1.472-1(a) provides that any taxpayer permitted or required to take inventories pursuant to section 471, including section 1.471-5, may elect to apply the LIFO method.

Section 1.472-2 provides that the adoption and use of the LIFO inventory method is subject to the requirement, inter alia, that the taxpayer file an application to use such method specifying with particularity the goods to which it is to be applied. Section 1.472-3 provides that such election must be filed with the return for the year of which the method is first used. A statement of this election is to be attached to the return. The statement should be on Form 970, pursuant to the instructions printed thereon, or in such other manner as is acceptable to the Commissioner. Such statement shall be accompanied by an analysis of all inventories.

Section 472(c) provides that a taxpayer may use LIFO only if the taxpayer establishes to the satisfaction of the Secretary that the taxpayer has used no procedure other than LIFO in inventorying such goods to ascertain the income, profit or loss of the first taxable year for which the method is used for the purpose of a report or statement covering such taxable year to shareholders or for credit purposes. Section 472(e)(2) extends this conformity requirement to subsequent years.

Section 472(g) provides that all members of the same group of financially related corporations shall be treated as one taxpayer for purposes of subsections (c) and (e)(2).

Section 472(f) provides that the Secretary shall prescribe regulations permitting the use of suitable published governmental indexes to be used in applying the LIFO inventory method.

You indicated that [REDACTED] is a dealer in securities pursuant to section 1.471-5 of the regulations. As discussed above, it would appear that [REDACTED] was, in fact, a "dealer" for those purposes. Therefore, based on the holding of Rev. Rul. 60-

321, 1960-2 C.B. 166, it appears that [REDACTED] is entitled to elect to use the LIFO method. The main questions are (1) the number of LIFO pools that [REDACTED] should use, and (2) the definition of an "item" within each pool. With respect to the first question, section 1.472-8(c) of the regulations provides that items of inventory in the hands of wholesalers, retailers, jobbers, and distributors shall be placed into pools by major lines, types, or classes of goods. In determining such groupings, customary business classifications of the particular trade in which the taxpayer is engaged is an important consideration. We are not aware of any "customary business classifications" with respect to the application of LIFO to securities dealers. This is probably due to the fact that it is our understanding that few securities dealers use the LIFO inventory method. Further, the use of LIFO to value securities for financial statement purposes is contrary to generally accepted accounting procedures.

The number of pools to be established by a taxpayer using the LIFO inventory method is a factual matter to be determined from all the circumstances. Technical normally encourages examining agents to settle pooling issues rather than submit the issue to the National Office for resolution. To our knowledge, the National Office has never addressed the issue of the proper number of LIFO pools for securities dealers. To fully analyze the issue as it relates to [REDACTED], we would need a complete factual development of the case. However, based on the facts as presented to us, it appears that, as a minimum, [REDACTED] should have separate pools for precious metals, corporate bonds, government bonds, foreign currencies, and stocks.

The second specific issue deals with the definition of an item within each pool. Again, Technical has never addressed this issue in the context of a securities dealer. However, to lessen the possibility of a distortion, Technical would support as narrow a definition of an item as possible. For example, suppose a securities dealer had one pool for all its precious metals and all such metals were one item. If the LIFO pool began with 100 ounces of silver (at \$10 an ounce), the base-year cost of the pool would be \$10,000. If, in the next year, the pool consisted of 1000 ounces of gold (at \$500 an ounce), the base-year cost would remain at \$10,000 because the base-year cost of the "item" does not change. Accordingly, there would be no change in the LIFO value of the inventory. This clearly is a distortion. Gold and silver should be separate items. In this example, gold should be a "new item" so that the base-year cost of the pool is \$500,000 (1000 x \$500). A narrow definition of an item is supported by Amity Leather Products Company v. Commissioner, 82 T.C. 726, 733 (1984), where the Tax Court stated:

Because the change in the price of an item determines the price index and the index affects the computation of increments or decrements in the LIFO inventory, the definition and scope of an item are extremely important to the clear reflection of income. If factors other than inflation enter into the cost of inventory items, a reliable index cannot be computed. ... A narrower definition of an item within a pool will generally lead to a more accurate measure of inflation (i.e., price index) and thereby lead to a clearer reflection of income.

The next issue you ask us to address is whether [redacted] properly elected the LIFO inventory method. Without examining the Forms 970, we cannot definitively conclude whether [redacted] properly elected LIFO. However, it is generally our position that a taxpayer's LIFO election may be valid despite its failure to fully comply with all the requirements of Form 970. For example, in LTR 7821005, the Service ruled that the taxpayer's LIFO election was valid, even though the Form 970 contained the following errors and omissions:

- (1) The Form 970 was not signed;
- (2) The taxpayer failed to disclose that it employed the retail method;
- (3) The taxpayer provided a very brief description of its pools;
- (4) The taxpayer failed to disclose its method of determining price indexes;
- (5) The taxpayer selected an improper method of valuing increments; and
- (6) The taxpayer did not provide a detailed analysis of its inventories.

The last issue you ask us to address relates to the LIFO conformity requirement. Technical has examined [redacted]'s financial statements for the relevant years and concurs with you that there does not appear to be any LIFO conformity violation. However, you state that you have not yet examined any of [redacted]'s reports to creditors, and if a report to a creditor is issued using a non-LIFO method, the Service may terminate the taxpayer's LIFO election. See Rev. Proc. 79-23, 1979-1 C.B. 564.

We also point out that Rev. Proc. 79-23 also provides that the Service may terminate a taxpayer's LIFO election if the

taxpayer fails to maintain adequate books and records with respect to its LIFO inventory and all computations incident thereto.

On January 23, 1991, you sent to us a copy of the proposed Revenue Agent's Report setting forth adjustments be taken into account in calculating the proof of claim to be filed with the bankruptcy court in this case. You asked that we review this document and comment on these proposed changes. Thomas Moffitt has been in contact with Michael Wilder in this regard and what follows is a summary of the advice given on the issues raised by this proposed report.

The proposed report would require that [REDACTED] not maintain a single dollar value LIFO inventory pool in each of the following categories: precious metals, interest bearing obligations, and foreign currencies. After consulting with Technical and in light of the concepts discussed above we have recommended that the proposed report not require an increase in the number of pools which [REDACTED] used in these categories. However, we suggested that the items in the pools be scrutinized in conformity with the concepts set out above to determine if [REDACTED] is using appropriate item categories.

The proposed report would require that [REDACTED] use double extension rather than the link-chain method for calculation of inventory changes in the interest bearing obligations, and foreign currencies pools. As stated in your November 9, 1990, request for tax litigation advice, [REDACTED] must comply with the regulations regarding the application of the appropriate index in order for section 472 to authorize the use of LIFO inventory. Section 1.472-8(e)(1) requires the taxpayer to satisfy the district director that the use of an index method or the double extension method would be either impracticable or unsuitable in view of the nature of the pool before the link-chain method will be approved. Thus, if in the specific factual circumstances of this case you believe that an index method or the double extension method are practicable or suitable it would be appropriate to assert an adjustment based on the use of one of these methods rather than link-chain.

Finally you asked whether the use of inventories for foreign currency is improper. This is a factual question. Section 1.471-1 requires inventories, "...in every case in which the production, purchase, or sale of merchandise is an income-producing factor." If these foreign currencies are actually held for sale to customers then we see no reason why they should not be subject to the inventory rules.

If you have any further questions or comments, please
contact Thomas Moffitt of this office at FTS 566-3521.

MARLENE GROSS

By: Richard L. Carlisle
RICHARD L. CARLISLE
Senior Technician Reviewer
Branch 1
Tax Litigation Division